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STATE FOR MATT BRYZA

USEU FOR AMBASSADOR GRAY

DOE FOR JOHN MIZROCH

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TAGS: ENRG ECON LG

SUBJECT: LATVIA: SCENESETTER FOR USG PARTICIPANTS AT THE  
BALTIC REGIONAL ENERGY FORUM

Classified By: Ambassador Catherine Todd Bailey for Reason 1.4(d)

**¶11. (U) Summary:** Your visit to the June 11-13 Baltic Regional Energy Forum provides an excellent opportunity to view first hand both the challenges and opportunities that Latvia (and the other Baltic States) faces as it strives to craft an energy policy that: enhances security, ensures a stable energy supply, adapts to new EU regulations concerning conservation, and creates viable opportunities for the private sector to address the energy challenges of the future. This cable provides background on the energy market in Latvia, with an aim to enhance USG participants' understanding of the context and limitations within which panel discussions will take place. Helping Latvia think strategically about the geopolitical realities of the region (particularly its heavy dependence on Russia for basic energy supplies) and creating opportunities for American businesses--these are the two key goals of this year's Baltic Regional Energy Forum. End Summary.

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A Heavy Reliance on Russia  
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**¶12. (U)** One of the stark realities shaping Latvia's energy policy is the country's heavy reliance on imports. One hundred percent of its natural gas and most of its oil and oil products are imported from Russia. Electricity imports vary from negligible in a wet year - when Latvia's hydroelectric power stations can meet domestic demand - to approximately 60 percent imported in dry year. This heavy dependence on imported energy (especially from Russia) colors virtually every aspect of energy policy in Latvia; it will loom in the background of most (if not all) of the panel discussions that take place at the forum.

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Natural Gas  
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**¶13. (U)** The Latvian natural gas company, Latvijas Gaze (LG), has sole authority to import, store and distribute natural gas in Latvia. Privatization of LG began in 1995 with sales of equal minority stakes to German and Russian companies. The privatization was completed in early 2002. Currently, it has two groups of strategic investors: E.ON Ruhrgas International AG with 47.23 percent interest; and Russian interests represented by Gazprom (34 percent) and Itera Latvia (16 percent). This overall privatization strategy, while often criticized for giving Russian companies a controlling share, has ensured good relations with Gazprom. There have been no problems with supply interruptions of gas

from Russia, and LG has adequate funds to operate reliably. Gazprom has been moving Latvia to market pricing for gas. The wholesale price per 1000 cubic meters (tcm) of gas increased by 50 percent starting January 1, 2007, to USD 215 per tcm. LG expects another price increase in 2008 (by about 30 percent) which will bring the costs of natural gas for Latvia close to Western European levels. Retail prices to consumers across all categories have increased by an average of 30 percent compared to last year.

**¶4. (U)** Latvia maintains an underground natural gas facility - the third largest in Europe - at Inculkans, about an hour from Riga. Gas from Russia is injected into the underground storage formation in the summer, and then withdrawn during the winter season to be delivered to consumers in Latvia and Russian regions near the Latvian border. Latvijas Gaze is hoping to expand the Inculkans facility and ultimately to develop other large underground storage sites in Latvia--a development that depends on Latvia's future intergovernmental relations with Russia.

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Oil  
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**¶5. (U)** Ventspils Nafta (VN), a large holding company known mainly for its oil terminal and extremely convoluted shareholding structure, is the largest player on the Latvian oil transit market. Besides the oil transit business, VN owns a number of real estate businesses, several printing and publishing businesses, and a 49.94 percent share in another large company, Latvian Shipping. In the past, VN trans-shipped between 12 and 14 percent of Russia's crude and oil products exports each year. However, since Russia started developing its own oil terminals and stopped crude oil

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shipments through the pipeline to Ventspils in late 2002, VN has confronted a much more competitive and uncertain environment. The existence of competitive export routes has heightened VN's perceived vulnerability to the vagaries of Latvian-Russian political relations.

**¶6. (C)** The domination of VN and related oil business in Ventspils by long time mayor Aivars Lembergs and his associates has further distorted the picture. Lembergs, currently in jail on charges of large scale corruption and bribery, was a personal impediment to relations with Russian oil suppliers (depending on who you ask, either because he stood up for Latvian interests or because he swindled the Russians out of money, or some combination of the two). Until his legal situation is resolved and until there is some evidence that he no longer holds sway over VN operations, it is hard to imagine a decision by Russia to resume shipments to Ventspils.

**¶7. (SBU)** The VN privatization saga began in 1997 and was completed only in October of 2006, when the government auctioned off its entire remaining 38.62 percent stake to a number of bidders. Vitol Group, an international oil trader based in the Netherlands with turnover exceeding USD 80 billion in 2005, emerged as the largest buyer. The company bought 34 percent of VN shares through its daughter-company Euromin. Vitol Group has since increased its interest in VN to 47.9 percent. Latvijas Naftas Transits (LNT), a consortium of several local oil transit companies, owns 38 percent of shares, while the rest is owned by various small shareholders. The fact that a large block of shares is now owned by a Western buyer without any known ties to Latvia's oligarchs is in itself a modest success of the last round of VN privatization.

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Electricity  
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**¶8. (U)** Latvia relies heavily on electricity imports. In 2006, Latvia imported 2.809 billion kWh of electricity from Russia,

Estonia, and Lithuania. Latvenergo, Latvia's energy utility, operates three hydropower stations, two large thermal power plants that provide heat and electricity to the Riga region, and a network of small-scale district heating plants that account for some 70 percent of Latvia's electricity generation. It also controls the transmission and distribution systems. Latvenergo has estimated that investments of up to USD 2 billion are needed over the next decade to upgrade the various components of the electrical system.

¶ 9. (U) Privatization of Latvenergo has been the most sensitive issue compared to all other Latvian energy companies, and successive Latvian governments have been unable to achieve consensus on how to proceed. At present, Latvenergo is fully state-owned, and we do not foresee any GOL attempts to privatize it in near future.

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Ignalina Nuclear Power Plant  
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¶ 10. (U) Lithuania's Ignalina Nuclear Power plant plays a vital part in meeting Latvia's overall energy needs. Lithuania pledged to decommission the plant in 2009 as part of its commitments to join the EU. All three Baltic States (plus Poland) are negotiating the construction of a replacement plant--slated to be completed in 2015 (though probably later). An initial agreement involving only the three Baltic states envisioned each country holding a 1/3 share of the project. However, Lithuania and Poland announced in January that Poland would be brought into the project as a partner, amidst complaints by Estonia and Latvia that they had not been consulted.

¶ 11. (C) This issue of Polish participation and the allocation of shares of energy production has created considerable tension between the participating countries. Latvia felt very poorly done by the Lithuanian efforts to bring the Poles into the new Ignalina nuclear plant, without consultations among the original partners. Lithuania has proposed that it hold a 34 percent stake in the project, with the other three partners each receiving 22 percent. This scenario would give Lithuania plus Poland a majority share in the new plant. Estonia and Latvia have counter-proposed that Poland only receive 15 percent. It should be emphasized that in the

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period between the closure of Ignalina in 2009 and the completion of any successor nuclear plant, the Baltic states will face an even greater reliance on Russian natural resources to meet energy needs. For its part, Latvia has proposed construction of a 400 MW, USD 650 million electrical generation plant to meet its demand during this gap. A feasibility study on the plant is due in July, with construction envisioned for 2009-2011.

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Nordstream Pipeline  
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¶ 12. (U) The Nordstream gas pipeline project, which would build a direct link from Russia to Germany under the Baltic Sea, has been controversial in Latvia and the broader Baltic Sea region. The Baltic States felt boxed out when Germany and Russia proposed the project, as such a direct link could allow Russia to supply gas to Western Europe directly while potentially playing political games with former Soviet states. Scandinavian governments, particularly Sweden, are concerned about the environmental risks associated with building a pipeline under the Baltic Sea; these concerns are magnified by the fact that a considerable amount of unexploded ordinance from the two world wars lies unaccounted for along the sea bottom.

¶ 13. (C) Like Ignalina, the Nordstream project has also

created tensions among the Baltic States and with Poland. In May an advisor to the Polish PM met with the Latvian PM's foreign policy advisor, Peteris Ustubs. According to Ustubs, the Polish advisor began the meeting by assaulting Latvian policy, especially on energy. She charged that Latvia was "a traitor" to the Baltics and Poland on energy issues, cutting side deals with Moscow on gas storage and the Nordstream pipeline. She then alleged that there was a "secret deal" negotiated as part of the Latvian-Russian border treaty that dealt with energy and economic issues. The degree of suspicion on all sides regarding these issues even significantly complicated the process of whom the Government of Latvia was willing to invite to the Baltic Regional Energy Forum.

¶14. (C) Whether due to a simple lack of policy on the issue, or due to a desire by the Latvian government to "hold its cards close to its vest," no clear Latvian policy has emerged regarding Nordstream. Ugis Sarma, Director of the Energy Department at the Latvian Ministry of Economics, told post that the GOL views Nordstream neutrally--simply as a commercial matter, with some environmental dimensions. According to Sarma, the GOL's main interest would be in building an "interconnector" to link the Nordstream pipeline to a proposed underground gas storage facility in Latvia at Dobele. Sarma noted that such a connection would only be built if such storage were necessary for Gazprom--to ensure a stable supply of gas for customers in Germany. He added that, regardless of whether the Nordstream pipeline is built or not, Latvia will remain heavily dependent on Russia for gas.

¶15. (C) Comment: There is no shortage of interest or passion when it comes to energy in Latvia and how it affects Latvian relations with the other Baltic States. The confluence of security, economic, and environmental interests make the matter one of the key strategic challenges for Latvia in the short, medium, and long terms. While a resurgent Russia will undoubtedly continue to use its natural resources and control of energy infrastructure assets as political weapons, Latvia has no other viable options to meet its energy needs for now.

The Baltic Regional Energy forum should help policymakers think strategically and long-term as they develop policies in an environment where there are no easy answers, only difficult tradeoffs. In addition, the forum will encourage Latvia to look west, not just east, as it considers policy options--and thereby foster increased trade ties between the US and Latvia. End Comment.

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